

The Email MBA

11.16.10 – The Income Statement (aka P&L)

Whether you are thinking about building a financial model to represent the market potential for your start-up, preparing your publicly traded company to announce quarterly earnings to the Street, or striving to impress your boss at the next strategy meeting, you must not only have a firm grasp of your financials but achieving a mind-numbingly intimate knowledge of this financial information is of paramount importance, wherever you are, whatever you are selling, for success in the marketplace.

I was recently sitting in the audience for a “pitch-slam” where entrepreneurs were presenting their nascent businesses to a mixed panel of venture capitalists and angel investors. Out of thirty presenters only one individual had any grasp of their market and the ability to address the question posed to every presenter by the panel, how ‘big’ can the new product be in five years. Guess who won the competition? Yep, the one entrepreneur who could address the market sizing and product potential question.

The Income Statement is the tool used to model answers to address certain questions posed by the panel or potential investors. It is the document used by companies to represent revenue received over defined periods of time. After working through the line items of the Income Statement the pot of gold at the end of its rainbow is the determination of net income, or loss, for a specific period of time.

Our goal here is get to a place where we are able to analyze a set of financials, this collection of documents includes, in addition to the Income Statement, the Balance Sheet and Cash Flow Statement. We will also address the often over-looked Statement of Stockholder Equity. We are going to address these financial documents by studying a public company whose innovative products continue to permeate deeper into our lives, that is Cupertino, CA-based Apple, Inc. We will also build a pro forma, or forward-looking, financial model for our start-up company, Boston, MA-based Widgets, LLC. Once a fundamental understanding of these documents is achieved we can begin to slice and dice them with the intent to raise and address questions that may not be publicly stated by management. Perhaps you are thinking of purchasing some shares of Apple (Nasdaq: AAPL)? Well, doing your homework, or diligence, on the Company certainly includes assessing the Company’s financial position and prospects – we will get to covering this due diligence effort as well.

So let’s roll up our sleeves and get to it. In order to begin, where can we even find the Income Statement for AAPL? My favorite free go-to resource for public company financial information is Yahoo Finance (<http://finance.yahoo.com>). I entered the ticker, scrolled down to Financials and copied the annual (not quarterly) Income Statement that displays the last three-years of data through the end of the third quarter. Financial information is published quarterly, covering ninety days of financial history through the end of March, June, September and December. However the information is typically not reported to the Street until about a month after quarter-end in late April, July, October and January, this delay allows for preparation time.

The Income Statement goes by a number of different names including the Statement of Financial Performance, Earnings Statement, Statement of Operations and the Profit and Loss Statement. From now on we will use this last moniker and shorten it even further to simply, the P&L. The first line of the P&L displays **Total Revenue**, and thus the term “**top-line**” has become a common term to describe the total amount of cash that a

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company has earned in a defined period of time. In our case we see that AAPL has earned \$65,225,000 over a one-year period through the end of the third quarter or 3Q10. Actually that number is \$65,225,000,000, you will notice that the numbers are presented in thousands to make the document easier to read by reducing the zeros. Wow, that's a

View: [Annual Data](#) | [Quarterly Data](#) All numbers in thousands

Period Ending	Sep 25, 2010	Sep 26, 2009	Sep 27, 2008
Total Revenue	65,225,000	42,905,000	32,479,000
Cost of Revenue	39,541,000	25,683,000	21,334,000
Gross Profit	25,684,000	17,222,000	11,145,000
Operating Expenses			
Research Development	1,782,000	1,333,000	1,109,000
Selling General and Administrative	5,517,000	4,149,000	3,761,000
Non Recurring	-	-	-
Others	-	-	-
Total Operating Expenses	-	-	-
Operating Income or Loss	18,385,000	11,740,000	6,275,000
Income from Continuing Operations			
Total Other Income/Expenses Net	155,000	326,000	620,000
Earnings Before Interest And Taxes	18,540,000	12,066,000	6,895,000
Interest Expense	-	-	-
Income Before Tax	18,540,000	12,066,000	6,895,000
Income Tax Expense	4,527,000	3,831,000	2,061,000
Minority Interest	-	-	-
Net Income From Continuing Ops	14,013,000	8,235,000	4,834,000
Non-recurring Events			
Discontinued Operations	-	-	-
Extraordinary Items	-	-	-
Effect Of Accounting Changes	-	-	-
Other Items	-	-	-
Net Income	14,013,000	8,235,000	4,834,000
Preferred Stock And Other Adjustments	-	-	-
Net Income Applicable To Common Shares	\$14,013,000	\$8,235,000	\$4,834,000

lot of MacBooks and iPhones. You can also observe the dramatic rise in revenue over the three years reported (\$32B in '08, \$42B in '09 and \$65B in '10). Knowing the top-line value allows us to do some fun back of the envelope calculations, like how many computers has AAPL sold in the past year. If we take \$65B and divide it by say \$1,500 as an average product purchase price we come up with 43,333,333 products sold. Now we know that AAPL sells everything from iPods to iPhones to laptops to towers and AppleTV and more, so our quick calculation based upon an arbitrary average purchase price is likely not to be very accurate. We can find answers to this question and more accurate product sales information in the quarterly and annual reports – these are the 10Q and 10K reports that publicly traded companies file with the Securities and Exchange Commission, and can be found at <http://sec.gov> among other places like the investor tab on a publicly traded Company's website – we will detail these documents downstream.

The ~\$65B in revenue is the sales earned over a defined period, this value may not necessarily represent all of the cash that has come into the business in the specified time; for other non-revenue sources of cash may include capital raised from various

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forms of fundraising efforts through mechanisms such as angel investors, venture capital or an IPO (initial public offering) – we will allocate a lot of time in the future to fundraising – or additional cash sources such as time shifted payments for products or services to be delivered in the future or even past-due obligations.

A critical element of top-line revenue is defining at what time the revenue earned is accurately recognized. For example, think about your personal financial matters – on pay day you may enter your paycheck into the register, perhaps the following evening you will go for a nice dinner out on the town and then debit your register to represent a decrease in your accounts value. This is the common form of ‘cash accounting’ that we use to maintain our personal finances however, the way a company tracks their finances is a rather different methodology called ‘accrual accounting’. To differentiate between the two methods, in most simple terms, in cash accounting income is recorded when it is received and deductions are claimed when expenses are paid, simple to digest because this is how we maintain our personal checkbooks. In accrual accounting transactions are recorded when an order is placed and a product or service delivered, this method does not care about when the money for the goods and services is actually paid or received – more plainly, the transaction is recorded on the books when the event occurs not when the receivable or payable is exchanged.

How to determine the purchase or sale transaction date in the accrual method is key. Income is recorded when a product, service, contract etc. is completed or delivered, while an expense is recorded when all goods have been delivered – in both cases, completion is the trigger for recording. Generally, a company can use the cash method if revenues are less than \$5M and must adopt the accrual method if revenues are greater than \$5M.

Let’s examine another example, Widgets, LLC is going to build a new online store for AAPL to upgrade the popular iTunes store and AAPL will pay Widgets, LLC \$6M to do so. It is planned that the product delivery date will require six months. In a cash accounting example the payment by AAPL would be recorded as a \$6M P&L expense in month six however, using the accrual accounting method an accrued expense of \$1M per month will appear on the balance sheet (we will dissect the balance sheet following the P&L). Because no cash has actually changed hands yet no expense will appear on the P&L for AAPL. Instead when the bill is paid to Widgets there will only be a balance sheet entry where cash is reduced and accrued expenses also reduced by the \$6M total. Head hurt yet? Good – you’re thinking, already getting smarter, faster. Hang tight as this will make more sense as we move along.

Getting back to our AAPL P&L example above – following top-line revenue is the **Cost of Revenue** of \$39.5B for the 3Q10 period. This value represents essentially the total direct cost to manufacture and deliver all of those iPods, iPhones and MacBooks, it does not include indirect costs such as salaries. If the Cost of Revenue is subtracted from the Total Revenue it provides the **Gross Profit** (where $65,225 - 39,541 = 25,684$). If we divide Gross Profit by Total Revenue we arrive at AAPL’s **Gross Margin** (where $25,684 / 65,225 = 39.3\%$). A Gross Margin of nearly 40% is nothing to sneeze at, consider grocery stores and retailers who operate very low margin businesses, often on the order of razor-thin single digits, while some businesses such as in software companies the

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gross margins can be upwards of 70% to 90+%. Would you rather invest in a low gross margin or high gross margin business?

Moving down the P&L we begin examining **Operating Expenses** for AAPL, these are different expenses than what are represented in the Cost of Revenue. These Operating Expenses are frequently referred to as fixed costs or overhead costs and are essentially the costs to run the business even if there were no products being sold and no revenue coming in. Another interesting exercise is to examine if these fixed costs are correlated to or are rising as revenue is rising and if so to what extent. Looking at the **Research & Development Operating Expense** for the last three years we see a negligible increase. It must be that for about \$1.5B per year the innovators in hold-up at the Cupertino labs are able to crank out fantastic new paradigm-shifting products and valuable upgrades to the old. While we observe the **Selling General and Administrative Operating Expense** is clearly on the rise over the three-year period, perhaps linked to the voluminous number of new hires required to work at the Genius bar in all of the new Apple stores opened at a shopping center near you. If we sum the Operating Expenses and subtract that value from the Gross Profit we are left with the **Operating Income or Loss** [25,684 – (1,782 + 5,517) = 18,385]. This value is critical as it indicates whether or not a company is profitable or hemorrhaging cash.

The next set of values are **Income from Continuing Operations** or non-core business expenses. The **Total Other Income/Expenses** may frequently include interest income earned from cash balances invested in t-bill's (these popular 90-day government notes will be detailed downstream) or interest owed on issued bonds or other debt instruments (again, bonds and other debt instruments will be focused on in a subsequent post). Add the Total Other Income/Expense to Operating Income or Loss and there you have **Earnings Before Interest and Taxes**, commonly this line item will also consider Depreciation and Amortization to yield the frequently used term of **EBITDA**. By then backing out the Income Tax Expense we arrive at the final value on the P&L, that is...**Net Income** (and hopefully this is a positive and not a negative number).

So there you have our walk through the Income Statement. Naturally, this financial statement does not tell you everything about a business, for example how management is intending to effectively address a new competitive threat or why a new product launch has been delayed. Therefore it is vital to digest the other financial statements available - which is tee-d up for next week's Email MBA post. As we will see, it is imperative to dig in beyond the numbers to understand what is transpiring in the Board room and in the hallways of corporate America but understanding the numbers is a critical element and our first order of business. The Email MBA will empower you with the ability to peer behind the corporate veil – sit tight we are just getting started. The Email MBA and you, smarter, faster.